How does depreciation shelter my principal reduction on my annual tax return.

The "tax shelter" on real estate caused by depreciation deduction shelters your principal payments on your mortgage because it is a "pretend" loss that you get to claim on your tax return.

It works this way.

First, when you make a loan payment on an investment property, only the interest portion of that payment is deductible as a business expense on your tax return. So if you make $10,000 of loan payments during the year, and $9,000 of that was interest, and $1,000 was principal, then your tax accountant will let you deduct the $9,000 from your net taxable income, reducing your taxable income by that amount. However, the other $1,000 is not an allowable deduction. Therefore, your bank account is reduced by the full $10,000 but only $9,000 of that is a deduction. The other $1,000 is considered simply moving an asset from your right pocket to your left pocket because you converted cash in your bank account to equity in your property. Thus, no deduction is permitted for that change of an asset on your balance sheet.

Now, when you calculate your depreciation allowance for your income tax return, you are not actually reporting a real "loss" because the IRS provides a schedule you must use to calculate your depreciation. You use those tables instead of hiring an appraiser to go out and actually estimate the real "loss" (wearing out of your physical property - which is what depreciation really is). In fact, in most cases, any "wearing out" (actual depreciation) of your property is usually offset by the real appreciation (increase in market value) of your property. So there is no "real loss" on your property. The property in a normal market is worth the same or more so no real depreciation (loss of value) has actually happened.

The way you calculate "real" depreciation is to find the replacement cost today (not when you purchased the property) of the improvements and subtract from that the market value of the improvements today. In a normal market, when you do that calculation, the increase in market value of the property usually offsets and real "wearing out" that has happened on the improvements. *So no real loss by virtue of depreciation has actually happened! It is a PRETEND LOSS!*

However . . . and this is where the tax shelter happens . . . The IRS lets you pretend that there was depreciation (wearing out) of the property by providing those depreciation scheduled for you to pretend that there was depreciation. The IRS title for that is "cost recovery" not depreciation because it is permitting you to "recover" the cost you paid for the improvements when you purchased the property. But the fact is that even though your property is probably worth the same or more than what you paid for it, you get to *pretend* that you lost the amount of money they permit you to claim as depreciation.

So, while your bank account was reduced by the principal portion of your mortgage payment and you did not get to deduct those payments as a business expense, you offset that by a pretend (paper loss) expense of depreciation on your tax return. So as long as the pretend depreciation (cost recovery) deduction on your tax return is greater than the principal payment on your mortgage, all of your principal payment is "sheltered" by that pretend loss. When your depreciation deduction is lower than the principal payments on your mortgage, you begin to lose that "shelter" because not all of that principal payment is sheltered by the pretend depreciation allowance. Usually that is because the payment schedule on your mortgage has reduced the principal so much that the interest portion of your payments has gone down and the principal portion has gone up to an amount more than your depreciation allowance. When that happens, in theory, it is time to sell or exchange the property for a more valuable property which will allow you to reset your depreciation schedule on the new property back to where you again have that tax shelter.

So that is how you get tax shelter to make your principal payments on your mortgage not taxable income. You pretend you lost value on your property when you did not really experience the loss. That pretend loss offset the non-deductible principal payments on your mortgage.